***United States Court of Appeals***

***for the Second Circuit***


# BRIEF FOR APPELLANT

ORIGINAL
WITH PROOF
OF SERVICE

# 76-5003

## UNITED STATES COURT OF APPEALS

*for the*

## SECOND CIRCUIT

In re:

LOIS ADLMAN,

BANKRUPT,

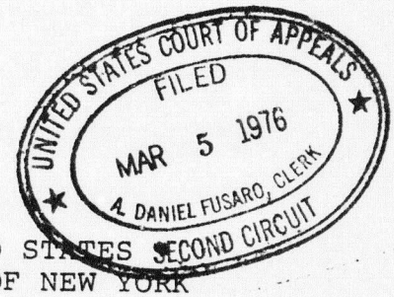
BANK OF PENNSYLVANIA,

Plaintiff-Appellee,

-against-

LOIS ADLMAN,

Defendant-Appellant.




ON APPEAL FROM AN ORDER OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF NEW YORK

BRIEF OF DEFENDANT-APPELLANT

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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|---|---|
| In re: | |
| LOIS ADLMAN, | |
| Bankrupt. | |
| BANK OF PENNSYLVANIA, | |
| Plaintiff, | |
| -against- | |
| LOIS ADLMAN, | |
| Defendant-Appellant. | |

## STATEMENT OF CASE

This is an appeal from an order of the United States District Court for the Eastern District of New York (Platt, D.J.) which affirmed a judgment of the Bankruptcy Court (Radoyevich, B.J.) denying the defendant a discharge in bankruptcy, pursuant to Section 14c(4) of the Bankruptcy Act.

The discharge was denied on the ground that "defendant did, at a time subsequent to the first day of the twelve months preceding the filing of the petition in bankruptcy, transfer her real property, and repay loans on policies of insurance, with the intent to hinder, delay or defraud her creditors, all as specified in Section 14c(4) of the Bankruptcy Act."

It is the contention of the Bankrupt that the order of the District Court affirming the judgment of the Bankruptcy

Court was erroneous and must be reversed as a matter of law.

## THE FACTS

Lois Adlman and her husband, Edward C. Adlman, filed voluntary petitions in bankruptcy on March 22, 1974, and were, on that date, adjudicated Bankrupts.

The Bankrupt's husband, was engaged during 1972 and 1973 in the purchase and development of real property in Pennsylvania and was a general partner in the limited partnership known as Leesport Gardens Company. The Bankrupt was a housewife and took no part in the management or operation of the various real estate ventures in which her husband had been involved.

Prior to 1972, Edward had sustained a heart attack and had been confined to the intensive care unit of the North Shore Hospital located at Manhasset, New York.

On October 23, 1972, Leesport obtained a loan from the Bank of Pennsylvania. In connection with this loan, the Bankrupt and her husband executed and delivered to the Bank of Pennsylvania a guarantee of any loans the bank might make to Leesport. This loan was subsequently paid by Leesport to the bank.

The guarantee executed by the Bankrupt was a continuing guarantee. The Bankrupt testified she executed this instrument at her home at the request of her husband because her husband explained that it was something needed in business

and that it was important to have both of their signatures under the law of Pennsylvania.

On or about June 11, 1973, Leesport desired to borrow $25,000.00 from the bank and a financial statement was delivered to the bank by Edward C. Adlman which purported to be a statement of personal assets of husband and wife. Listed among the assets was the residence of the husband and wife located at Sands Point, New York, title to which had been conveyed to the Bankrupt.

Sometime during the year 1973, Edward C. Adlman was in a serious automobile accident and sustained severe personal injuries. During the year 1973, the financial position of the husband deteriorated and the husband was under tremendous financial pressure.

On October 12, 1973, the Bankrupt sold the family home to the uncle and aunt of Edward C. Adlman for the sum of $125,000.00, subject to a first mortgage. The Bankrupt realized approximately $60,000.00, by reason of the sale. A lease was entered into between the Bankrupt and the new owners. The said lease was the usual standard form used in connection with the rental of a one family dwelling.

Because of the ill health of her husband and his inability to obtain insurance in the future by reason of his heart condition, the Bankrupt almost simultaneously with the closing of title drew checks on her checking account from the proceeds of sale paying loans outstanding on some of the insurance policies upon the life of her husband and prepaying

premiums on other policies, one of which was due thirteen (13) days after date of payment and the other due about two (2) months from date of payment.

Approximately five and one-half months after the payment of these loans and premiums, the Bankrupt filed her petition.

Under Section 166 of the Insurance Law of the State of New York, the various policies of insurance on the life of Edward C. Adlman and on the life of his father, which were owned by the Bankrupt or in which she was the designated beneficiary, constituted exempt assets.

The Bank of Pennsylvania, a creditor of the Bankrupt, commenced an action seeking to deny the Bankrupt's discharge on various grounds.

The Bankruptcy Judge dismissed all of the grounds except one, the third count of the complaint. It found that the conversion of non-exempt assets, to wit, the proceeds of the sale of the Bankrupt's real property, into exempt assets (the insurance policies), was fraudulent and thereby denied the Bankrupt a discharge.

The District Court affirmed the judgment of the Bankruptcy Court. The Bankrupt appeals from the order of the District Court.

## QUESTIONS PRESENTED

1. Did the District Court in affirming the judgment of the Bankruptcy Court apply the proper standard of proof

required to sustain a finding of intent under Section 14c(4) of the Bankruptcy Act?

Bankrupt submits that this question must be answered in the negative.

2. Did the mere acquisition of exempt property consisting of the repayment of loans on policies of insurance with non-exempt funds by the insolvent debtor five and one-half months prior to the filing of her petition in and of itself constitute fraudulent conduct on behalf of the Bankrupt?

Bankrupt submits that this question must be answered in the negative.

## POINT I

### THE DISTRICT COURT FAILED TO APPLY THE PROPER STANDARD OF PROOF REQUIRED TO SUSTAIN A FINDING OF INTENT UNDER SECTION 14c(4) OF THE BANKRUPTCY ACT.

It is a fundamental concept of the Bankruptcy Act that the provisions of Section 14c should not be extended by construction and must be construed strictly against the objector and liberally in favor of the bankrupt. RE KOKOSZKA, 479 F2d 990 (2nd Cir. 1973), aff'd on other grounds ____ U.S.___ 94 S.Ct. 2431; RE JONES, 490 F2d 452 (5th Cir. 1974).

What then is the quantum of proof required to sustain a finding of intent under Section 14c?

This court has held that in order to sustain a violation of this section the trial court must find that the transfer

or removal of the property in question was effected with actual intent to hinder, delay or defraud creditors, HALPERN v. SCHWARTZ, 426 F2d 102 (2nd Cir. 1970).

Or phrased in another way - the conversion of non-exempt assets to exempt assets on the eve of bankruptcy is not fraudulent as a matter of law. A factual pattern must be established to demonstrate an actual intent to defraud creditors. The mere transfer of non-exempt property into exempt property does not establish a fraud on creditors.

To establish actual intent the following factors must be demonstrated:

Proof of a systematic scheme (IN RE WHITE, 221 F. SUPP. 64)

A calculated scheme (IN RE FREUDMANN, 495 F2d 816 (2nd Cir. 1974) Cert. Den. 419 U.S. 841, 95 S.Ct. 72)

A corrupt purpose and design (KANGAS v. ROBIE, 264 F 92)

A fraudulent purpose to defraud creditors (FORSBERG v. SECURITY STATE BANK OF CANOVA, 15 F2d 499 (8th Cir. 1926).

And the quantum of proof required to establish an actual fraudulent intent must be predicated upon evidence that is "clear and convincing", PITTMAN v. UNION PLANTERS NAT. BANK & TRUST CO., 118 F2d 211 (6th Cir. 1941); having "some quality of substantive evidence," LOVE v. MENICK, 341 F2d 680 (9th Cir. 1965).

The District Court in upholding the Bankruptcy

Judge's denial of a discharge concluded that the Bankruptcy Judge "could well have and apparently did infer the requisite intent..."

Thus, the District Court acknowledged that the refusal of the Bankruptcy Judge to grant appellant her discharge was predicated upon an inference of a violation of Section 14c(4).

"Inferences alone cannot be the basis for refusing a discharge in bankruptcy, particularly where there is no evidence to support the inferences and reasonable explanations are given." IN RE TUMEN, 58 F. SUPP. 210 at 212, affirmed 146 F2d 268.

The Bankrupt will demonstrate that the refusal to grant the Bankrupt a discharge based upon an inference of intent as found by the Bankruptcy Judge and affirmed by the District Court was clearly erroneous.

## POINT II

## THE ACQUISITION OF EXEMPT PROPERTY WITH NON-EXEMPT FUNDS BY AN INSOLVENT DEBTOR IMMEDIATELY PRIOR TO BANKRUPTCY IS NOT FRAUDULENT PER SE.

The acquisition of exempt property with non-exempt funds by an insolvent debtor immediately prior to bankruptcy is not fraudulent per se. WURDICH v. CLEMENTS, 451 F2d 988 (9th Cir. 1971); IN RE DUDLEY, 72 F. SUPP. 945, aff'd per curiam, GOGIN v. DUDLEY, 166 F2d 1023 (9th Cir. 1948); LOVE v. MENICK, 341 F2d 680 (9th Cir. 1965); SCHWARTZ v. SELDON, 153 F2d 334 (2nd Cir. 1946).

Let us examine the record to determine what proof exists to support a finding of actual intent under Section 14c(4). In doing so we must be guided by the following criteria to establish proof of actual intent:

A. A systematic scheme; a calculating scheme

B. A corrupt purpose and design

C. A fraudulent purpose

D. Evidence that is clear and convincing

The evidence in this case reveals that the Bankrupt transferred her home, the real property in question, by deed dated October 12, 1973, to her husband's aunt and uncle for a valuable consideration, i.e., $125,000.00. At the same time, she entered into a lease with the owners of the property giving her possession of the premises as a tenant. The lease does not grant any privileges that would not be afforded to any other tenant of real property.

The sale of the property was subject to a first mortgage and the Bankrupt received approximately $60,000.00 from the sale. Out of the proceeds she made payments on insurance premiums due on insurance policies that were scheduled in her bankruptcy petition, she prepaid some insurance policies that were to become due within the next two months, and she paid insurance loans that had been obtained on these insurance policies.

There was no evidence of her knowledge of impending insolvency, that she had ever consulted an attorney in regard to bankruptcy, that she had knowledge that the insurance

payments would be exempt property, or that she had knowledge that her husband was on the verge of considering bankruptcy at the time she sold the house.

The Bankrupt was not a business woman. She took no part in the operation or management of her husband's real estate ventures. Primarily all of the obligations listed in her schedules were obligations as guarantor on obligations incurred by her husband. The only real assets she ever owned were her home and her insurance policies.

With her husband's health precarious by reason of his heart attack and auto accident, it was an act of prudence on the Bankrupt's part to preserve and protect her own future and that of her children by keeping the life insurance policies current and unencumbered. It was also prudent to prepay some of them knowing the temptation because of the family's hard times to use these funds in other ways.

That the life insurance policies were later discovered by the Bankrupt to be exempt assets is her good fortune and right under the exemption statutes of this State. She cannot be penalized for claiming these rights.

In LOVE v. MENICK, 341 F2d 680 (9th Cir. 1965), the Bankrupt, who one week prior to filing the petition, surrendered the policy on his life in exchange for its net cash value and, two days prior to filing the petition, deposited $1,000.00 of the money received in a federal savings and loan association, was held to be entitled to the $1,000.00 exemption.

The Court in LOVE stated:

> Appellant complied with the advice of his attorney, and the deposit of money derived from the surrender of an asset, a portion of which, absence surrender, would have already been exempt under the statute relating to life insurance, into an account of exempt quality, cannot be held, of itself, to constitute fraud.
> (341 F2d at 682)

The District Court by its affirmance, in effect, held that as a matter of law the conversion of the proceeds of sale into exempt insurance policies by the bankrupt was made with actual intent to defraud creditors solely by reason of the fact that the payment was voluntary and that such funds were removed from the bankrupt's creditors. This is not the test to vitiate a transfer of funds into exempt assets.

The Bankruptcy Judge in reaching his determination relied upon IN RE HIRSCH, 4 F. SUPP. 708.

In that case, four days after retaining an attorney to represent him in an insolvency proceeding and two days before executing an assignment for the benefit of creditors, the debtor repaid insurance loans on policies of insurance which he had taken out some years before in favor of his wife. Here the Court held that the payment of loans by the Bankrupt on such policies and/or the payment of advanced premiums on them when he knows he is insolvent and shortly before a petition in bankruptcy is filed is a fraud on then existing creditors and is sufficient to prevent the Court's approval of a composition.

Appellant does not quarrel with this result as the

trier of fact could readily find that the Bankrupt, a sophisticated businessman, after consulting his attorney, embarked upon a systematic scheme to convert non-exempt assets on the eve of an insolvency proceeding.

This is a far cry from the instant case where a housewife approximately five and one-half months prior to the filing of her petition in order to protect herself and her children in light of her husband's ill health and financial posture sells her home and converts the proceeds into the payment of insurance premiums and the repayment on loans on insurance policies.

Even assuming arguendo that the Bankruptcy Judge could draw an inference of bad intent from the conduct of the Bankrupt, it is equally clear that the very same conduct likewise raises an inference consistent with honesty and the lack of a fraudulent intent.

Where two inferences may be drawn from the conduct of the Bankrupt, one pointing to a guilty or bad intent, and the other consistent with honesty, it is the duty of the court to find in favor of honesty and the absence of a fraudulent purpose. IN RE WILLIAMS, 286 F 135.

The Bankruptcy Judge below in further support of his denial of a discharge to the Bankrupt cited Section 166 of the Insurance Law of this State - which creates the exempt status of insurance policies.

This section requires "actual intent to defraud creditors" in order to vitiate the exempt status of life

insurance policies. And the statute means just that.

In SCHWARTZ v. SELDON, 153 F2d 334, this Court held that the mere repayment of loans on an insurance policy by a Bankrupt while insolvent does not constitute a fraud on creditors without a finding of actual fraudulent intent under Section 166.

The Court stated:

> ...even if the finding be construed to mean that the bankrupt repaid the loans, the policy would not lose its exempt character unless the payment constituted a transfer made with "actual intent" to defraud creditors, as required by § 166 if exemption is to be defeated. See DOETHLAFF v. PENN MUT. LIFE INS. CO., 6 Cir., 117 F2d 582, 584, certiorari denied 313 U.S. 579, 61 S.Ct. 1100, 85 L ed 1536; 1 Moore, Collier on Bankruptcy, 840. We think the record contains no evidence justifying an inference of "actual intent" to defraud creditors.
>
> (153 F2d at 336)

> In other words, no actual intent to defraud creditors can be found from the mere transferring of one exempt fund into another exempt fund. Even the conversion of nonexempt property into exempt property by an insolvent contemplating bankruptcy has been held a transaction not intended to defraud creditors in the absence of evidence of extrinsic fraud. FORSBERG v. SECURITY STATE BANK, 8 Cir., 15 F2d 499, 49 ALR 915; 1 Moore, Collier on Bankruptcy, 840. Consequently the Metropolitan policy should have been held exempt from reach by the Trustee.
>
> (153 F2d at 337)

It is ironic that the Bankrupt's husband, a sophisticated businessman, who was the sole source of income in the family has been granted a discharge while the Bankrupt, a housewife with no business experience has been denied a

discharge. And the denial of that discharge is predicated upon an inference of intent unsupported by any factual proof in the record.

The Court below denied the Bankrupt a discharge without a shred of evidence to support a claim of actual fraud or even the legal fiction of constructive fraud. The sole basis for the denial of the discharge was the fact that the Bankrupt converted non-exempt property into exempt property. This circumstance in and of itself does not support a claim of actual fraud.

> An insolvent debtor may use with impunity any of his property that is free from the liens and the vested equitable interests of his creditors to purchase a homestead, for himself and his family in his own name. If he takes property that is not exempt from judicial sale and applies it to this purpose, he merely avails himself of a plain provision of the Constitution or the statute enacted for the benefit of himself and his family. He takes nothing from his creditors by this action in which they have any vested right. The constitution or statute exempting the homestead from the judgments of creditors is in force when they extend the credit to him, and they do so in the face of the fact that he has this right. Nor can the use of property that is not exempt from execution to procure a homestead be hel to be a fraud upon the creditors of an insolvent debtor, because that which the law expressly sanctions and permits cannot be a legal fraud.
>
> The suggestion of counsel in the case at bar that, though the property thus acquired by the bankrupt might be exempt, yet he should be denied discharge in bankruptcy because of so acquiring it, is not persuasive. We do not think one should be penalized for merely doing what the law allows him to do. FORSBERG v. SECURITY STATE BANK OF CANOVA, 15 F2d at 501.

## CONCLUSION

The order of the District Court should be reversed and an order entered herein directing that a discharge be granted to the Bankrupt.

Respectfully submitted,

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MATTHEW FEINBERG
Of Counsel

STATE OF NEW YORK )
COUNTY OF NEW YORK) ss.:

ROBERT LA GRASSA, being duly sworn, deposes and says that deponent is not a party to the action, is over 18 years of age and resides at 62-20 60th RD MASPETH, N.Y.

That on the 5th day of MARCH, 1976, deponent personally served the within BRIEF OF DEFENDANT-APPELLANT upon the attorneys designated below who represent the indicated parties in this action and at the addresses below stated which are those that have been designated by said attorneys for that purpose.

~~By leaving ____ true copies of same with a duly authorized person at their designated office.~~

By depositing 2 true copies of same enclosed in a postpaid properly addressed wrapper, in the post office or official depository under the exclusive care and custody of the United Stated post office department within the State of New York.

Names af attorneys served, together with the names of the clients represented and the attorneys' designated addresses.

CROWE MC COY AGOGLIA + ZWEIBEL
ATTORNEYS FOR CREDITOR BANK OF PENNSYLVANIA
80 EAST OLD COUNTRY RD.
MINEOLA, N.Y. 11501

Roberta LaGrassa

Sworn to before me this
5th day of March, 1976

Michael DeSantis

MICHAEL DeSANTIS
Notary Public, State of New York
No. 03-0930908
Qualified in Bronx County
Commission Expires March 30, 1977